Legacy Trust

Investment Perspectives

Halloween Edition: What's Spooking the Markets?

October 2023

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Key Takeaways

- 🎃 Higher rates present headwinds for GDP growth and threaten companies with significant leverage.
- 🍬 Potential for inflation to reaccelerate, especially given recent energy volatility.
- 👻 Renewed focus on health of the consumer as savings are depleted and net charge-offs and delinquencies move off pandemic lows.
- 🧛 Global geopolitical risks bring a renewed sense of uncertainty to investors across multiple ongoing conflicts.

October 31st is near and as Halloween looms, our advisors have faced both tricks and treats in 2023. After strong equity market returns in the first half of 2023, the second half of the year has been more challenging.

Group/Investment	1H 2023	2H 2023	YTD
U.S. Large Cap			
S&P 500 TR USD	*16.89*	*-4.11*	*12.09*
U.S. Small/Mid Cap			
Russell 2500 TR USD	*8.79*	*-9.58*	*-1.63*
U.S. Small Cap			
Russell 2000 TR USD	*8.09*	*-10.69*	*-3.47*
International Developed			
MSCI EAFE NR USD	*11.67*	*-7.33*	*3.48*
International Emerging			
MSCI EM NR USD	*4.89*	*-6.17*	*-1.58*

Data through market close 10/24/2023

With just two months remaining in 2023, what's spooking the markets? More importantly, what should investors do about it?

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Despite strong economic data and GDP growth, there are a number of issues that have caused the rally in equities to pause in the second half of 2023. The S&P 500 has broken through its 200-day moving average, a technical signal that bears currently have the upper hand. The last time the S&P approached it's 200-day MA was in March of this year.

Below are some, but not all topics, currently spooking markets.

1. Higher interest rates for longer.

Interest rates continued to rise in recent months even as investors believe that the hiking cycle is coming to a close. Futures pricing indicates that the Fed is unlikely to further hike rates in its' final two meetings of the year (November 1st and December 13th). If the Fed were to hike, it would likely be at the final meeting of 2023 and in the magnitude of 25bp.

Even as expectations continue to firm that rates may be at or near peak, 10-year and 30-year yields currently hover around the 5% level. Investors are gradually coming to terms with policymaker's consistent "higher for longer" messaging with some weighing the possibility that rate cuts may not come until the second half of 2024. Futures pricing currently reflects three 25bp cuts by year-end 2024.

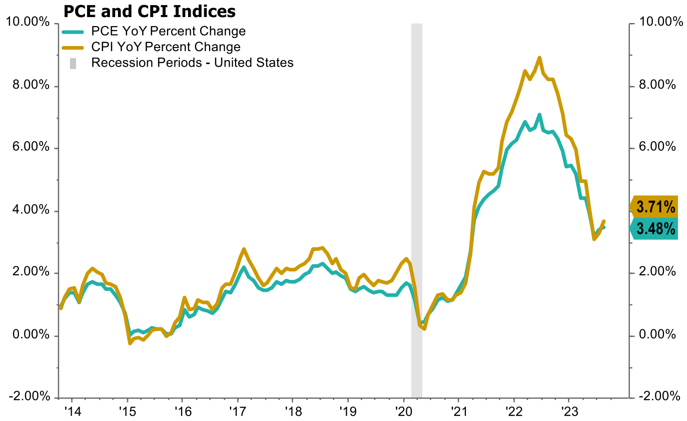
Higher rates present headwinds for GDP growth and threaten companies with significant leverage as they are forced to issue new debt at much higher rates as current issues mature.

The rate environment has been particularly cruel to rate-sensitive sectors that pay high dividends and are often bought for income generation. While it was not so long ago that yield starved investors had no other viable options, the current environment allows for steady yield from fixed income investments. Utilities are the worst performing sector (XLU -14.3% ytd vs S&P 500 +12.1%) with Real Estate the second worst performer (XLRE -8.8% ytd).

2. Potential for inflation to reaccelerate.

Inflation, measured by the Consumer Price Index (CPI), has shown ongoing progress towards price stability. The most recent CPI data (October 12th) indicated year-over-year inflation of +3.7%, well above the Fed's stated target of 2%. However, with wage growth outpacing inflation as measured by CPI, both the Fed and consumers likely can live with inflation remaining above 2%.

Despite all the progress made, the worry is that inflation picks back up and the Fed is forced to be more restrictive than current expectations. The aforementioned higher rate environment has flowed through to many sectors of the economy and has slowed economic activity. Should inflation reaccelerate, policymakers would be unlikely to introduce rate cuts, and may deem further hikes to be appropriate.


PCE and CPI Indices

A major cause for concern in the fight against inflation is energy pricing. WTI crude oil spent most of the first half of the year in the $70/barrel range. Supply and demand imbalances, paired with geopolitical tensions have seen crude rally as high as the mid-$90s in September, before settling in around the mid-$80s this week. While the energy category contributes less than 10% of total CPI, prices tend to swing more violently, with the potential for significant upside risk to headline CPI numbers.

While energy prices hit CPI directly, they also hit inflation figures indirectly as producers navigate higher costs both in production (oil is a key input in manufacturing) and delivery. Corporations then often split the burden with consumers, passing on price increases, with the balance hitting earnings margins.

Investors will get two additional readings before year-end of both CPI and the Producer Price Index (PPI). CPI will be released November 14th and December 12th. PPI will be released November 15th and December 13th.

3. Health of the Consumer.

A financially healthy consumer is essential for the U.S. economy. Households accumulated excess savings during the pandemic due to both direct payments by the government and reduced consumption as many sheltered in place. Those savings however, have been worked through as pent-up demand has been unleashed for multiple years at this point.

Now investors are mindful of a shift in consumer health as households face tightened financial conditions and persistent inflation.

Delinquencies and net charge-offs for both credit card debt and auto loans (both new and used) have moved sharply off pandemic lows. While credit card balances topped $1 trillion for the first time in August, delinquencies have leveled out to near pre-pandemic levels in recent quarters according to the New York Fed.

One positive note for consumer health- the largest liability for consumers as a whole, mortgage debt, is largely fixed rate and has been struck at or refinanced to rates that are very favorable for consumers.

4. Geopolitical Risk.

Markets do not like uncertainty. A number of concurrent geopolitical events have brought significant risk to investors both near and far. While war wages on in the Russia-Ukraine conflict, additional tensions have sprouted across the globe.

Strife in the Middle East has dominated news flow in recent weeks as tensions in the Gulf remain high with the Israel-Hamas conflict. The impact on U.S. equities has thus far been limited, but any sign of escalation (including drawing in Iran or other parties) could change that.

U.S.-China relations have remained an ongoing disruption that has come in and out of the foreground. The U.S. provided increased military and economic support to Taiwan while China demonstrates an ongoing willingness to pressure Taiwan. With tensions running high, President Biden and Chinese leader Xi Jinping plan to meet in November at the Asia-Pacific Economic Cooperation summit in San Francisco.

Legacy Trust employees and their children enjoy a costume party, spooky games, and candy at our annual Halloween Party; November 2022.

With plenty of topics spooking the market, what should investors do?

While we agree investors have cause for concern, we must zoom out and consider the complete macroeconomic environment. As long-term investors seeking compounding growth, we rarely face market environments without wrinkles that are spooky. The key is to be forward looking (like markets) and decipher how the balance of tricks and treats will shape long-term returns.